https://www.financial-planning.com/news/short-term-bonds-on-the-rise-as-interest-rates-decline

Short-term bonds on the rise as interest rates decline
By Rob Burgess
December 02, 2024, 5:33 p.m. EST

The Federal Reserve is now a few months into its long-awaited string of interest rate cuts.

And while that may be welcome to some, yields on money market funds are shrinking.

Low-duration investing strategies including short-term bonds may offer some relief, said Jon McCardle, president of Summit Financial Group of Indiana in Lafayette, Indiana. This shift was also the subject of the recent Payden & Rygel webinar, "Rethinking Cash: The Long-Term Benefits of Short-Term Bond Investing."

Kerry Rapanot, director and low-duration portfolio strategist at Payden & Rygel, said these may be ideal for looking for conservative alternatives to money market funds.

And even while yields on money market funds are declining, assets in money market funds reached an all-time high of $7 trillion this past month. Rapanot said this was "eye popping."

"Which kind of brings us to a bit of surprise to see fund balance continuing to increase again," she said.

As investors think about moving cash out of money market funds, a low-duration strategy makes sense, said Rapanot.

"A low-duration strategy is for investors looking to balance safety, liquidity and enhanced income, and this offers a compelling solution," she said. "We're currently in a period of increased interest rate volatility and lower credit risk premiums, which means the additional yield investors earn by buying higher-risk securities are lower than normal."

Rapanot said they didn't think it was a good idea to take on credit risk that doesn't fairly compensate the investor.

"We have a similar view for interest rates, where we do not see value in taking on additional risk where you're not compensated," she said.

Part of that risk comes from the expectations around further rate cuts. Rapanot said at the beginning of the year, the market priced in seven cuts. Now, at the close of 2024, "we've had three and we may or may not get a fourth."

Low-duration strategies offer investors the potential to earn more than money market funds or bank deposits, said Rapanot. They invest in bonds with maturities as long as five years, compared to the 397-day maturity limit on money market funds.

"This enables an investor the potential to lock in longer-term yields, as well as take advantage of price appreciation as interest rates fall, something money market funds cannot do as effectively," she said.

Low-duration strategies invest across the fixed income universe from treasury bills to structured bond credit.

"This investment diversification can generate greater returns while maintaining liquidity," she said.

These do offer higher potential for return than money market funds, but they come with greater price volatility due to owning longer maturities, and the inclusion of credit, said Rapanot.

"However, the investments remain short-term enough to limit this risk, especially as bonds quickly approach maturities and their prices pull to par, which helps to stabilize returns," she said. "By its nature, a low-duration portfolio should be liquid."

Not every individual holding needs to be able to function as liquidity, though, said Rapanot.

"Though money market securities have less price risk and lower trade costs than corporate bonds, both can be sold to generate liquidity," she said. "Through active management, portfolios can maintain liquidity and participate in total return opportunities."